No. 12639

In the United States Court of Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

BIRCH RANCH AND OIL COMPANY, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE PETITIONER

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OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 385-408) are reported at 13 T.C. 930.

JURISDICTION

The Commissioner determined deficiencies in income and declared value excess profits taxes for the fiscal years ended September 30, 1941 and 1942, and mailed notice of the deficiencies to taxpayer on April 30, 1945. (R. 25-26.) On July 13, 1945, within the permitted 90-day period, taxpayer filed a petition for review with the Tax Court for a redetermination of the deficiencies under the provisions of Section 272 of the Internal Revenue Code. (R. 1, 5-25.) Taxpayer subsequently

filed an amended petition (R. 33-52) which, among other things, raised an issue as to its right to a carry-back deduction to the year 1942 for a net operating loss sustained in 1944 (see R. 51). The Commissioner filed an answer to the amended petition (R. 53-55) and, after a brief hearing on June 30, 1947 (R. 56-99), the Tax Court, in a memorandum opinion (R. 100-115), held that it had jurisdiction of the carry-back deduction issue. *Birch Ranch & Oil Co.* v. *Commissioner,* decided March 24, 1948 (1948 P-H T.C. Memorandum Decisions, par. 48,040). A further hearing was held October 11, 1948. (R. 117.) Taxpayer abandoned issues other than the carry-back deduction issue (R. 387) and filed a supplement and amendment to the petition relating to the carry-back deduction issue (R. 127-131). The Commissioner filed an answer (R. 131-133) and further hearing in the case was had on February 15, 1949 (R. 149). The decision of the Tax Court was entered March 3, 1950. (R. 411.) The Commissioner's petition for review by this Court (R. 412-423) was filed May 19, 1950 (R. 4, 423-424), and properly invoked the jurisdiction of this Court under Section 1141(a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948.

QUESTION PRESENTED

Whether the circumstances of the case are such as to entitle the taxpayer-corporation to a "taxes paid" deduction under Section 23 (c) of the Internal Revenue Code, or to an "interest paid" deduction under Sections 23 (b), 122 (a) and (d)(2), in computing its 1944 net operating loss for the purpose of a carry-back deduction in the taxable year 1942 under Sections 23 (s) and 122.

STATUTE AND REGULATIONS INVOLVED

The pertinent statute and Treasury Regulations are set forth in the Appendix, *infra.*

STATEMENT

The Tax Court's findings of fact (R. 387-397) are as follows:

Taxpayer is a Nevada corporation having its principal office at Los Angeles, California. It was organized on October 15, 1934, by A. Otis Birch and his wife, M. Estelle C. Birch, who on the same date also organized the Birch Securities Company and the Birch Holding Company. To the taxpayer-corporation Birch and his wife transferred a 21,000-acre tract of land known as the Conaway Ranch and certain other property. To the Birch Securities Company Birch and his wife transferred 1,594 bonds, each of $1,000 face value, issued by Reclamation District No. 2035 (California), certain stocks, and other assets. The two transfers comprised all of their property. All shares of the taxpayer-corporation and of the Birch Securities Company were transferred to the Birch Holding Company, which issued 49 per cent of its shares to Birch and 51 per cent to Birch's wife. (R. 387-388.)

Birch was president and in control of the affairs of all three corporations. The Birch Securities Company and the Birch Holding Company were formed for convenience and conducted no business. The taxpayer-corporation operated the Conaway Ranch, raising and selling crops and sheep. (R. 388.)

The Conaway Ranch is situated in Yolo County, California, about five miles from Sacramento. It was purchased in 1914 and thereafter enlarged by the Birch Oil Company, a partnership in which Birch and his wife, the wife's parents, and Birch's nieces (hereinafter called the Hopkins sisters) held interests. (R. 388.)

At the time of the initial purchase, the Sacramento and San Joaquin Drainage District, created under the laws of California, was making surveys in the area for a

flood control project, and the reclamation board of the state later informed the Birch Oil Company that if it would construct a levee across the ranch adjacent to a proposed Yolo bypass, an assessment would be made against all lands in the drainage district to pay for the construction and for flowage rights. Desiring to develop its land, the Birch Oil Company later petitioned the supervisors of Yolo County to create a reclamation district which would comprise the ranch, and in April, 1919, the supervisors approved the establishment of Reclamation District No. 2035. B. F. Conaway, Birch's father-in-law, C. Harold Hopkins, the husband of Birch's niece, and a local attorney were appointed District trustees. A program of improvements, estimated to cost $2,264,740, was authorized, and commissioners were named who apportioned the cost of the improvements among lands in the District according to the benefits to be received, and filed with the treasurer of Yolo County assessments against the lands to meet such cost. (R. 388-389.)

The Birch Oil Company, under direction of the District's engineer, constructed the improvements, which consisted of many miles of roadways, canals, ditches, bridges, pumping plants, and other structures, at a cost of slightly over $2,000,000. It financed the work, and after completion in 1924 received a warrant, dated January 5, 1925, directing that the District, through the treasurer of Yolo County, pay it $2,000,000. (R. 389.)

On January 23, 1925, 2,000 bonds of the District, each of a par value of $1,000, were offered at auction to provide the necessary funds, and Birch purchased all of them, giving the $2,000,000 warrant in payment. These bonds bore six per cent interest, payable on January 1 and July 1 of 1925 and each year thereafter on presentation of an interest coupon to the county treasurer; 227 bonds were to mature on January 1 of 1935 and a like

number on January 1 of each succeeding year, ending with maturity of the last 184 on January 1, 1943. Principal and interest were payable out of moneys collected by the treasurer of Yolo County from assessments against the benefited lands, which assessments were to be deposited "into the main county treasury", but "credited to the bond fund" of the District, as provided by Section 3480, Article II, c. 1, Title 8, Deering's Political Code of California. (R. 389-390.)

Pursuant to a contract of 1924 Birch and his wife purchased the Hopkins sisters' interest in the ranch and Birch Oil Company, and in 1926 they purchased the wife's parents' interest. By virtue of these acquisitions and the purchase of small adjacent parcels of land they came into ownership of the entire ranch, then consisting of about 21,000 acres. The ranch was coterminous with Reclamation District No. 2035, except for 1,300 ranch acres which lay outside the District and 240 District acres which lay outside the ranch. (R. 390.)

In buying the interests of the Hopkins sisters, Birch paid them $1,000 cash and 786 District bonds.[1]

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[1] In this connection the stipulation of facts states (R. 138-139, 140):

> 9. In the meantime, the Hopkins sisters, being desirous of disposing of their interests in the Conaway Ranch, by agreements dated January 1, 1924, sold such interests to Birch and Mrs. Birch for $787,000, an amount designed to pay them their proportionate part of the Birch Oil Company funds invested in the ranch. Under the agreements each of the sisters agreed to accept bonds of Reclamation District No. 2035 in the principal amount of $393,000 and cash in the sum of $500. Birch and his wife agreed to cause the district to issue bonds in an amount of at least $800,000, which were to constitute a prior lien on all of the property in the district, and further promised to deliver on or before February 1, 1925, to each of the sisters the amount of the bonds and cash called for by the agreements. Birch and his wife were to have immediate and absolute possession and control of the properties acquired from the Hopkins sisters and were to be entitled to all rents and profits of every

Simultaneously, he and his wife agreed to buy back from them the 786 bonds at face value in specified annual installments on January 1 of each year from 1926 to 1934, and as security for performance they placed their remaining 1,214 bonds with trustees empowered to sell and make good any default by them on the contract. The Hopkins sisters, however, reserved the right not to sell on any installment date. During the first six years Birch and his wife paid for and received 476 bonds, as contemplated by the contract.

Because of financial difficulties they thereafter ceased to purchase installments of the remaining 310. But instead of invoking action by the trustees, the Hopkins sisters granted them a time extension without release from the obligation to buy. Prior to 1937 Birch and his wife sold ten of their District bonds to Lula Minter, a cousin of Birch, and 86 to the Great Republic Life Insurance Company, of which Birch was president and a director. (R. 390-391.)

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kind therefrom and were to assume all liabilities and burdens incident to the ownership thereof. The bonds not having been issued at the time of the agreements on January 1, 1924, Birch gave to each of the sisters his promissory note in an amount equal to the amount of the bonds she was entitled to receive under the agreements. The notes were to run for 10 years and were to draw interest at 6 per cent per annum from January 1, 1924, for a period of 5 years, and at 7 per cent thereafter. Birch had the option of paying the notes in full at any time prior to the expiration of the 10 year period.

* * * * *

13. Upon receipt of the bonds of the district, Birch delivered to each of the Hopkins sisters $393,000 par value of such bonds, or a total of $786,000 pursuant to the agreements of January 1, 1924, whereunder he and his wife had acquired from the Hopkins sisters all of the interests of the latter in the Conaway Ranch. Upon delivery of the bonds, the Hopkins sisters delivered to Birch the promissory notes covering the purchase price of their interests in the ranch which had been received from him at the time of the January 1, 1924 agreements. At the same time they made formal conveyance to Birch and his wife of all their interests in the Conaway Ranch.

During the years 1925-1930 Birch and his wife paid to the county treasurer of Yolo County on call of the assessment against the ranch the amounts necessary to meet interest payments on the bonds, and the Hopkins sisters collected their interest from the treasurer on presentation of the matured coupons. In succeeding years Birch bought the coupons of the Hopkins sisters as they matured, and deposited them with the treasurer, receiving a receipt and credit on the assessment against the ranch. After the taxpayer-corporation acquired the ranch in 1934, it too purchased at face value matured interest coupons from the Hopkins sister and from Lula Minter, turning them in to the county treasurer. It did not buy matured coupons on the 86 bonds held by the insurance company, and that company's successor in interest eventually brought suit to enforce collection of interest. The suit was settled by the taxpayer-corporation's purchase of the 86 bonds and accrued interest in 1940 for $65,000. (R. 391-392.)

No amount was ever paid into the Reclamation District by Birch and his wife or by the taxpayer-corporation for the purpose of paying off the bonds. But prior to maturity of the first 227 bonds and in 1935 the original issue was refunded by 2,000 new six per cent bonds of $1,000 face value, of which 50 were to mature on January 1 of 1945 and of each succeeding year. (R. 392.)

To test the legality of the original issue the District trustees filed a complaint with the Superior Court of Yolo County, and after consideration of the evidence the court on March 2, 1925, entered a decree that "said bonds are a valid, legal obligation of said Reclamation District No. 2035 * * *". The refunding bonds were likewise held a legal obligation of the District by decree entered in a similar proceeding on June 25, 1935. The proceedings were not contested. (R. 392.)

Since its organization in 1934 the taxpayer-corporation has operated the Conaway Ranch and has borne all costs and expenses of maintaining and operating the improvements of the Reclamation District, treating such disbursements as part of its expenses in operating the ranch in a manner which would be no different if there were no reclamation District, whether formal or actual, and the District has no expenses which are not taken care of by the taxpayer-corporation. For its ranch operations the taxpayer-corporation keeps a set of books on the basis of cash receipts and disburements. (R. 392.)

The officials of California counties are lenient with the owners of assessed lands in reclamation districts, and, while there was no express agreement, the treasurer of Yolo County refrained, in and after 1937, from making any calls on the taxpayer-corporation for payments or declaring defaults or taking foreclosure action against the ranch, being aware that the taxpayer-corporation was in no position to pay an assessment. The taxpayer-corporation nonetheless accrued on its books and deducted on its income tax returns an amount of $120,000 a year for which a call could have been made to provide the county treasurer with moneys necessary for the payment of the annual six per cent interest on the $2,000,000 face value bonds. It continued to buy at face value the maturing interest coupons on the 310 bonds of the Hopkins sisters and the ten bonds of Lula Minter, paying $18,600 and $600 a year, respectively, for them. (R. 393.)

The Commissioner allowed a deduction of the $600 plan to Lula Minter, but disallowed the rest of the $120,000 claimed. The taxpayer-corporation contested such disallowances for 1937 and 1939 in a proceeding before the Tax Court, Docket No. 109993. The Tax Court held that the $18,600 paid to the Hopkins sisters

was deductible, and sustained disallowance of the rest. *Birch Ranch and Oil Co.* v. *Commissioner,* decided April 20, 1944 (1944 P-H T. C. Memorandum Decisions, par. 44,128), affirmed January 6, 1946, 152 F. 2d 874 (C. A. 9th). This decision was based on a finding that the taxpayer-corporation kept its books for ranching operations on a cash, not on an accrual basis, and had made no payments other than the $600 and the $18,600. (R. 393.)

On September 30, 1943, the taxpayer-corporation held the 86 bonds acquired from the life insurance company; the Birch Securities Company held the 1,594 transferred to it at organization; the Hopkins sisters held 310 subject to the sale contract with Birch and his wife; and Lula Minter held 10. (R. 394.)

On March 15, 1944, Birch and his wife bought the remaining 310 bonds from the Hopkins sisters and the Birch Securities Company was liquidated and dissolved before the close of the fiscal year on September 30. The Birch Securities Company had been suspended since 1938 for failure to pay a state tax. (R. 394.)

Thus at the close of the fiscal year 1944 Birch and wife held directly 310 of the 2,000 bonds of the District; the Birch Holding Company held 1,594 from the liquidation of the Birch Securities Company; the taxpayer-corporation held 86; and Lula Minter 10. (R. 394.)

In March, 1943, the taxpayer-corporation and Birch and his wife gave to several individuals a written option to purchase the Conaway Ranch and all the District bonds. (R. 394.)

During the period 1937 until late in 1943 the taxpayer-corporation made no cash payment to the county treasurer to provide interest on the bonds and received no call to make a payment. In 1943, however, funds became available to it, and on October 13, 1943, the

treasurer made a call for $58,565.92, payable November 12. The taxpayer-corporation advised the treasurer that it could not pay the amount until later and would submit to a delinquency penalty. In reply the treasurer explained that the penalty was "part and parcel of the Call" which was "for interest only". On December 28, 1943, the Birch Securities Company transmitted to the treasurer coupons from 166 bonds and advised that the trustees for the Hopkins sisters would present coupons from 1,278 bonds. It requested remittance of $49,320 to cover the accrued interest. The following day the taxpayer-corporation paid the assessment call and a penalty of $5,856.59 by its check for $64,422.51 drawn in favor of the county treasurer, and the treasurer remitted $49,320 interest to the Birch Securities Company on January 8, 1944. On April 10, 1944, the treasurer made another call, for $53,721.65, payable May 10. The taxpayer-corporation paid this call and a ten per cent delinquency penalty of $5,371.94 by its check for $59,093.59 dated June 28, 1944. On August 12, 1944, the taxpayer-corporation gave to the treasurer its check for $37,325.28 in satisfaction of the unpaid portion of a call dated December 1, 1935, together with penalty. Before making this remittance the taxpayer-corporation inquired of the treasurer by letter if the treasurer would pay the interest coupons in arrears upon receipt of the amount. On September 20, 1944, it paid the treasurer $60,769.49 in satisfaction of a call dated September 8, 1944. In making calls, the treasurer computed an amount which, with any balance on hand, was sufficient to provide $60,000 for the semiannual interest due on the bonds, and amounts paid as penalties were reflected in his computations. The four payments which the taxpayer-corporation made during its fiscal year 1944 aggregated $221,610.87. Soon after the col-

lection of money by call the treasurer paid interest on the bonds, but no interest was ever paid without such preceding collection. (R. 394-395.)

On its tax returns for the fiscal years ended September 30, 1941, and 1942, the taxpayer-corporation claimed a deduction of $120,000 on account of the tax due Reclamation District No. 2035, and for each year the Commissioner disallowed the deduction "except as to $19,200 paid to the Hopkins sisters and Miss Minter". On July 7, 1947, after affirmance of the Tax Court's decision in Docket No. 109993, the taxpayer-corporation paid to the Collector $12,398.85 on account of the deficiencies determined in its income and declared value excess profits taxes for the fiscal year 1941. As there had been no assessment of the determined deficiencies, the payment was credited by the Collector to a suspense account and not applied in satisfaction of a tax. (R. 395-396.)

On its return for the fiscal year ended September 30, 1944, the taxpayer-corporation claimed a deduction of $118,890.87 as taxes paid to Reclamation District No. 2035, and reported a net loss of $84,179.37 for the year. In a report dated January 23, 1947, addressed to the taxpayer-corporation, the revenue agent in charge of the Los Angeles division recomputed a net loss of $186,-899.37 for the year, and, in so doing, allowed a deduction of $221,610.87, or the amount actually paid to the treasurer of Yolo County on account of the District taxes and penalties. (R. 396.) In a subsequent report, dated December 8, 1947, deduction of the $221,610.87 was disallowed on the ground that (R. 396-397)—

> there was no real or actual obligation outstanding against the taxpayer, since Reclamation District No. 2035 was comprised exclusively of the taxpayer's property, and since A. Otis Birch and his wife, Estelle Birch, the sole stockholders of the Birch

> Ranch and Oil Company hold substantially all the bonds of the Reclamation District.
>
> * * * * *
>
> As the interest received by A. Otis Birch and his wife, Estelle Birch, is nontaxable, the amounts claimed as taxes paid by the Birch Ranch and Oil Company is considered non-deductible.

As a consequence of this disallowance, the Commissioner determined that the taxpayer-corporation had no net loss carry-back from the fiscal year 1944 to the fiscal year 1942. (R. 397.)

On the basis of these facts, the Tax Court held that the taxpayer-corporation is entitled under Section 23 (c) of the Internal Revenue Code to a "taxes paid" deduction for the $221,610.87 it paid to the county treasurer in 1944 and, accordingly, that the taxpayer-corporation had a net operating loss for 1944 which it may carry back and deduct in 1942. (R. 399-408.)

STATEMENT OF POINTS TO BE URGED

The Commissioner's statement of points is contained in the record at pages 418-423. Briefly, the Commissioner contends that the Tax Court erred in holding that taxpayer's aggregate $221,610.87 payment in the fiscal year 1944 on "calls" by the county treasurer is deductible as "taxes". It is the Commissioner's position that the payment was and in any event should be treated as interest paid, rather than as taxes paid, and, except for the part of the payment received by the Hopkins sisters and Lulu Minter, is not deductible as interest paid.

SUMMARY OF ARGUMENT

Whether taxpayer is entitled to a net operating loss deduction for 1942 depends upon whether it had a net operating loss for 1944 to carry back to and deduct in 1942. Whether taxpayer had a net operating loss for

1944 depends upon whether it was entitled in 1944 to a deduction for the aggregate of $221,610.87 it paid on "calls" made by the county treasurer to pay interest on bonds issued by Reclamation District No. 2035.

1. The Tax Court erred in holding that the payment is deductible under Section 23 (c)(1)(E) of the Internal Revenue Code as "taxes paid". In order to be deductible under that section the payment must have been of taxes assessed against public benefits and allocable to interest charges. It was allocable to interest charges but it was not of taxes assessed against local benefits. Such taxes are assessments levied against a property owner as compensation for the benefits received or, in other words, to pay the cost of the improvements. Here the improvements involved were paid for at the outset by the only party against whom taxes could otherwise have been levied to pay for the improvements. The "calls" by the county treasurer therefore were not "calls" for an enforced contribution toward the cost of the improvements, either principal or interest, and were not for payment of "taxes". The whole arrangement, although authorized by the law of California, was merely one through which the Birches had Reclamation District bonds issued for their own purposes and which they used to create personal indebtednesses. This is true even though the Reclamation District is considered a separate entity, for the existence of the Reclamation District cannot change the purpose of taxpayer's payments.

2. The $221,610.87 was simply a payment of interest and, under the circumstances of this case, is not deductible as interest except for the part paid to the Hopkins sisters and Lulu Minter.

Section 23 (b) allows a deduction for interest paid "on indebtedness". Here there was no real indebted-

ness for interest other than on the bonds held by the Hopkins sisters and Lulu Minter. The payment of interest was made by the taxpayer-corporation, wholly owned by the Birches, and, except for the part received by the Hopkins sisters and Lulu Minter, was received by the Birches and their other two wholly-owned corporations, the Birch Securties Company and the Birch Holding Company. The payor and payees on those bonds were economically identical and no deduction for interest is allowable in such a case.

Moreover, Section 23(b) provides that no deduction for interest paid is allowable as to interest paid on indebtedness incurred to carry tax-exempt securities. For the purpose of computing net operating loss, such interest is the subject of a specific exception, addition or limitation. Section 122 (d)(2) provides that the tax-exempt interest shall be included in gross income and the interest paid to carry the tax-exempt securities is deductible against such included tax-exempt interest. According to the legislative reports, this exception was inserted for the purpose of insuring that only *economic* losses would be taken into account in computing net operating loss for carry-back purposes.

The interest received on the Reclamation District Bonds was tax-exempt. The interest paid on such bonds was interest paid to carry tax-exempt securities. Since the interest was paid by the taxpayer-corporation, a wholly-owned corporation of the Birches, and was received by the Birches and their other two wholly-owned corporations (except that received by the Hopkins sisters and Lulu Minter), no economic loss was involved. The separate entities of the wholly-owned corporations must be ignored in order to effectuate the Congressional intent, and, accordingly, the deduction for payment of interest, having been paid to carry tax-exempt securities, is not deductible.

3. Since Congress intended by Section 122 (d)(2) to insure that only economic losses would be taken into account in computing net operating loss, that purpose should not be thwarted by a holding that taxpayer's payments were of "taxes" and thus not subject to the limitations of Section 122 (d)(2). The Congressional purpose as to interest paid to carry tax-exempt securities is so clear as to require application even if taxpayer's interest payments may be considered interest paid through the medium of taxes. This is especially true when the payments were not of "taxes" in the usual sense of that word.

ARGUMENT

Taxpayer Had No Net Operating Loss for 1944 to Carry Back to and Take as a Deduction in the Taxable Year 1942 under Sections 23 (s) and 122 of the Internal Revenue Code

Section 23 (s) of the Internal Revenue Code (Appendix, *infra*) allows as a deduction "the net operating loss deduction computed under section 122". Under Section 122 the net operating loss deduction for a taxable year consists of such net operating losses of other years as may be carried over or carried back to the taxable year. In the present case the taxpayer-corporation is claiming that it had a net operating loss for 1944 which it may carry back to and take as a deduction in the taxable year 1942.[2] There is no dispute as to the right to carry back a 1944 net operating loss to 1942; the inquiry is whether taxpayer had a 1944 net operating loss to carry back. Section 122 (a) of the Code (Appendix, *infra*) provides that—

> the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

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[2] For a discussion of the operation of the pertinent statutes, see *Reo Motors* v. *Commissioner*, 338 U. S. 442.

One of the "exceptions, additions, and limitations provided in subsection (d)" is pertinent here and will be discussed later. However, at the moment it is sufficient to note that, generally speaking, the net operating loss for any given year is simply the amount by which the taxpayer's deductions for that year exceeds income of that year.

The instant taxpayer had an excess of deductions over income, and thus a net operating loss, for 1944 only if, in computing its 1944 net operating loss, it is entitled to take a deduction for the total of $221,610.87 it paid to the treasurer of Yolo County on "calls" made to pay the interest on bonds issued by Reclamation District No. 2035. The Tax Court held that the $221,610.87 was deductible under Section 23 (c) (1) (E) of the Code (Appendix, *infra*) as "taxes paid". This holding, we submit, is plainly erroneous. As we shall show, the payments aggregating $221,610.87 were of interest rather than of taxes and, as interest, are not deductible in the circumstances of this case.

A. *The $221,610.87 paid by taxpayer in 1944 to cover interest on the Reclamation District bonds did not constitute "taxes assessed against local benefits" and therefore is not deductible under Section 23 (c) (1) (E) of the Code as taxes allocable to interest charges*

Section 23 (c) (1) of the Code allows a deduction for taxes paid or accrued within the taxable year with certain exceptions. The exception contained in subparagraph (E) is of "taxes assessed against local benefits of a kind tending to increase the value of the property assessed". That subparagraph also provides, however, that—

> this paragraph shall not exclude the allowance as a deduction of so much *of such taxes* as is properly

> allocable to maintenance or interest charges; * * *. [Italics supplied.]

Thus, for taxpayer's payment of the $221,610.87 to be deductible under this section, the payment must not only have been allocable to interest, as it in fact was, but must have constituted "taxes assessed against local benefits".

Strictly speaking, a tax is an enforced contribution which goes into the Government Treasury as revenue to be used to support the Government.[3] Thus, an assessment made for benefits received from an improvement has often been held not to constitute a "tax" in the constitutional sense.[4] On the other hand, the word "tax" has two meanings—one which includes and one which excludes assessments for local benefits.[5] Under Section 23 (c) (1) (E) assessments for local improvements are called "taxes", although they are expressly excluded from deduction as taxes.

But a "tax" assessed against local benefits is an assessment which is levied for the purpose of defraying the cost of the improvement or, stated in another way, is levied as compensation or payment for the benefit re-

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[3] *Huse* v. *Glover,* 119 U.S. 543, 549; *Bank of Mount Hope* v. *Commissioner,* 25 B.T.A. 542.

[4] *Board of Directors* v. *Reconstruction Finance Corp.,* 170 F. 2d 430 (C.A. 8th); *Northwestern etc. Co.* v. *St. Bd. Equal.,* 73 Cal. App. 2d 548, 166 P. 2d 917; *Santa Clara Valley L. Co.* v. *Meehan,* 62 Cal. App. 531, 534, 217 Pac. 787; *Bennett* v. *Greenwalt,* 226 Iowa 1113, 1133-1134, 286 N.W. 722; *Charlotte* v. *Kavanaugh,* 221 N. C. 259, 20 S.E. 2d 97; *State ex rel.* v. *Bishop,* 169 Or. 448, 459, 127 P. 2d 736, 129 P. 2d 276; *State ex rel.* v. *Drainage District* v. *Thompson,* 328 Mo. 728, 737, 41 S.W. 2d 941; *Lake Arthur Drain. Dist.* v. *Bd. Com. Chav. Co.,* 29 N. Mex. 219, 221, 222 Pac. 389; *Loomis* v. *Rogers,* 197 Mich. 265, 163 N.W. 1018; *Logan, Auditor* v. *City of Louisville,* 283 Ky. 518, 522, 142 S.W. 2d 161.

[5] *Johnson County Comm'rs* v. *Robb,* 161 Kan. 683, 690, 171 P. 2d 784; *Northwestern etc. Co.* v. *St. Bd. Equal.,* 73 Cal. App. 2d 548, 553, 166 P. 2d 917; *Boston Asylum, etc.* v. *Street Commissioners,* 180 Mass. 485, 62 N.E. 961.

ceived from the improvement.[6] In the usual case a municipality or other governmental subdivision will issue and sell bonds to secure funds for a particular improvement and will tax the properties benefited by the improvement to supply the funds to pay off the bonds. In such a case the assessment or "tax" paid by the property owners, whether applied to the principal of or interest on the bonds, is in payment of the cost of the improvement in proportion to the benefit received therefrom. The "tax" consists of an enforced contribution toward the cost of the improvement. In contrast, if the property owner finances and thus has already paid for the improvement, any assessment against the property owner in connection therewith is not an assessment for local benefits and thus cannot be a "tax" assessed for local benefits.

Here there was no assessment for benefits received from the drainage improvements; the "calls" by the county treasurer were not made to pay the cost of the improvements, either principal or interest. At the time the drainage improvements were made in 1924, the Conaway Ranch was owned by taxpayer's predecessor, the Birch Oil Company, *and that company constructed and financed the improvements.* Reclamation District No. 2035, which issued the bonds involved here, covered all but 1,300 acres of the Conaway Ranch, plus 240 Dis-

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[6] *Board of Directors* v. *Reconstruction Finance Corp.*, 170 F. 2d 430, 433 (C.A. 8th); *Evans* v. *Ockershausen*, 100 F. 2d 695, 708 (C.A.D.C.), certiorari denied *sub nom. Smith* v. *Ockershausen*, 306 U. S. 633; *Northwestern etc. Co.* v. *St. Bd. Equal.*, 73 Cal. App. 2d 548, 553, 166 P. 2d 917; *Santa Clara Valley L. Co.* v. *Meehan*, 62 Cal. App. 531, 534, 217 Pac. 787; *Spring Street Co.* v. *City of Los Angeles*, 170 Cal. 24, 29, 148 Pac. 217; *Bennett* v. *Greenwalt*, 226 Iowa 1113, 1134, 286 N.W. 722; *People ex rel. N. Y. School for Deaf* v. *Townsend*, 173 Misc. 906 (N.Y.); *Charlotte* v. *Kavanaugh*, 221 N.C 259, 20 S.E. 2d 97; *Lima* v. *Cemetery Assn.*, 42 Ohio State 128, 130; *Vogt* v. *City of Oakdale*, 166 Ky. 810, 179 S.W. 1037; *Graham* v. *City of Saginaw*, 317 Mich. 427, 431-432, 27 N.W. 2d 42; *I.C.R.R. Co.* v. *City of Decatur*, 126 Ill. 92, 97, 18 N.E. 315.

trict acres which lay outside the ranch and against which the record does not show that an assessment was ever made. (See R. 347.) Since the Birch Oil Company, the owner of the ranch, was the owner of the only land which could be assessed to pay for the improvements and had in fact already paid for them, what would ordinarily be accomplished by an enforced contribution by way of a tax to pay for the improvements had already been accomplished voluntarily. The county or Reclamation District therefore was not in a position to levy a "tax" against the company to pay for the improvements and the payments made by taxpayer in 1944 were *not* in fact taxes assessed against, or to pay the cost of, the drainage improvements.

That the California statutes permitted the arrangement involved does not make the "calls" by the county treasurer demands for the payment of taxes assessed against local benefits. A demand or assessment by a political subdivision is not necessarily a "tax". See, e.g. *Mahler* v. *Commissioner,* 119 F. 2d 869 (C. A. 2d), certiorari denied, 314 U. S. 660; *Marx* v. *Commissioner,* 179 F. 2d 938 (C. A. 1st). After Reclamation District No. 2035 had been formed and had issued bonds in the amount of the cost of the drainage improvements on the land of the Birch Oil Company, that company itself held the bonds which were to be paid off through "calls" by the county treasurer against the company. Accordingly, the Birch Oil Company was both payor and payee on the bonds and interest thereon. In *Rindge Land & Navigation Co.* v. *Commissioner,* 2 B. T. A. 1179, the Tax Court long ago considered an arrangement of this type and stated (p. 1188):

> Where there is but one landowner, as in this appeal, a reclamation district is nothing more than a legal fiction—*an instrument created to permit the owner to issue bonds for its own purposes,* * * *. [Italics supplied.]

Whatever may have been the original intended purpose of the formation of Reclamation District No. 2035 and the issuance of Reclamation District bonds, the bonds were used merely to create personal obligations of the Birches. The Birch Oil Company, which had constructed and financed the drainage improvements, was a partnership in which Mr. and Mrs. Birch, Mr. Birch's nieces (the Hopkins sisters), and Mrs. Birch's parents (the Conaways) had interests. (R. 388.) On January 1, 1924, prior to the issuance of the Reclamation District bonds, the Hopkins sisters entered into agreements under which they sold their interests to Mr. and Mrs. Birch for $787,000 to be paid in Reclamation District bonds in the principal amount of $786,000 and cash in the sum of $1,000, the Birches agreeing to cause the Reclamation District to issue bonds in an amount of at least $800,000. (R. 138.) In 1926 Mr. Birch entered into an agreement with the Conaways, Mrs. Birch's parents, for the purchase of their interest in the ranch and in the bonds of the Reclamation District, paying cash therefor. (R. 142.) Since the bonds were payable by "calls" only against the owner of the Conaway Ranch, the Birches, the bonds in the amount of $786,000 delivered to and held by the Hopkins sisters merely represented the Birches' personal obligation to pay the purchase price of the sisters' interests in the Conaway Ranch. Such "calls" as may have been made by the county treasurer for either principal or interest on those bonds were simply "calls" for payments on the purchase price of the ranch, rather than "calls" for taxes consisting of a contribution toward the cost of the drainage improvements on the ranch, which would be leviable only against the land and had already been paid for by the then owner of the land. In 1943, after the Birches, pursuant to their agreement with the Hopkins sisters, had purchased $476,000 par

value of the bonds delivered to the Hopkins sisters, the Birches sold $10,000 par value of such bonds to Lulu M. Minter and $86,000 of the bonds to the Great Republic Life Insurance Company, a corporation of which Birch was president. (R. 143.) By transferring those bonds to third parties, the Birches simply created other personal obligations in themselves, for consideration received. The bonds which they did not transfer to third parties (except to their own corporation) were bonds on which they were both payor and payee and the issuance of such bonds served no purpose whatever.

The Birches themselves treated the bonds in the hands of third parties as their personal obligation to be paid for the consideration received for delivery of the bonds to the third parties, rather than as bonds requiring payment for the drainage improvements on the Conaway Ranch. Under their agreements with the Hopkins sisters the Birches agreed that they would buy back from the Hopkins sisters, without "calls", at face value in specified annual installments, the $386,000 in bonds they delivered to the Hopkins sisters in purchasing the sisters' interests in the Conaway Ranch and in the Birch Oil Company. (R. 390.) The Birches did in fact buy back 476 of the bonds during the first six years (R. 391) and on March 15, 1944, bought the remaining 310 bonds (R. 394). Similarly, in 1940 the Birches purchased the bonds held by the insurance company. (R. 391-392.) No amount was ever paid into the Reclamation District by the Birches or by the taxpayer-corporation (the Birches' wholly-owned corporation) for the purpose of paying off the bonds. (R. 392.) Interest payments were at first, during 1925-1930, paid by the Birches on call by the county treasurer (R. 391) but in succeeding years the Birches bought the interest coupons of the Hopkins sisters as they matured, deposited them with the county

treasurer, and received a receipt and assessment credit against the ranch and, in 1934, after the taxpayer-corporation acquired the ranch, it too purchased at face value matured interest coupons from the Hopkins sisters and from Lulu Minter (R. 391).

Payment on the bonds was previously regarded by the Tax Court as interest paid, rather than as taxes allocable to interest charges. In *Birch Ranch & Oil Co.* v. *Commissioner,* decided April 20, 1944 (1944 P-H T.C. Memorandum Decisions, par, 44,128), affirmed by this Court, 152 F. 2d 874, the Tax Court had before it the question of the deductibility of the interest payments made to the Hopkins sisters in 1937 and 1939. The Tax Court held the payments deductible as *interest paid.* Those interest payments were of course made directly to the Hopkins sisters and Lulu Minter, rather than through calls by the county treasurer, but the purpose of the payments was the same and the effect was also the same as if the payments had been made through calls by the county treasurer.

The incongruity of considering "calls" by the county treasurer as calls for taxes assessed to pay the cost of local improvements is even more evident when we come to the year 1944, for which taxpayer claims the taxes paid deduction. In that year (the fiscal year ending September 30, 1944) all of the 2,000 Reclamation District bonds (face value, $2,000,000) were held by the Birches or their wholly-owned corporations except the 310 held by the Hopkins sisters for part of the year and the 10 bonds held by Lulu Minter. The calls by the county treasurer not only were not for the payment of taxes assessed to pay the cost of local improvements, either principal or interest, but the majority of the total amount paid by the taxpayer-corporation (wholly owned by the Birches) pursuant

to the calls was necessarily repaid by the county treasurer to the Birches and their other two wholly-owned corporations, the Birch Securities Company and the Birch Holding Company.

The whole arrangement—including the issuance of Reclamation District bonds on which the interest was paid in the fiscal year 1944 on "calls" from the county treasurer—was merely one which the Birches used for their own purposes, not one calling for the payment of "taxes" for public benefits. The payments made by the taxpayer-corporation were simply of interest, not of taxes allocable to interest charges representing a part of the cost of public benefits. This is true even if the Reclamation District is considered a separate entity. The existence of the Reclamation District was part of the whole arrangement, but the fact that the District may have been a separate entity cannot change the arrangement into one calling for the payment of "taxes" consisting of the cost of the drainage improvements when the cost of the improvements had in fact already been paid.

Moreover, the Congressional purpose in enacting Section 122 (d)(2) of the Code (Appendix, *infra*) requires that the total $221,610.87 payment made by the taxpayer-corporation be treated as payment of interest and not of taxes, as we shall show under Point C, *infra*.

B. *The $221,610.87 Is Not Deductible under Sections 23(b) and 122 (a) and (d)(2) as "Interest Paid"*

As already shown, in 1926 after the Birches had purchased the Hopkins sisters' and the Conaways' interests in the Conaway Ranch and the Birch Oil Company, the Birches owned the Conaway Ranch and were thus liable for payment of the Reclamation Dis-

trict bonds and interest thereon. Bonds in the amount of $786,000 (786 bonds) had been given by them to the Hopkins sisters in the purchase of the Hopkins sisters' interests in the ranch and in the Birch Oil Company. Subsequently, the Birches, after having purchased 476 of the bonds from the Hopkins sisters pursuant to their purchase agreements with them, sold 10 bonds to Lulu Minter and 86 bonds to an insurance company. Accordingly, these bonds outstanding in the hands of third parties represented personal indebtednesses of the Birches—as to the Hopkins sisters, for the purchase of their interests and, as to Lulu Minter and the insurance company, for what were in effect loans.[7] The remaining 1,594 bonds were held by the Birches and merely represented an indebtedness to themselves, and thus no indebtedness at all, since they were both payor and payee on those bonds.

In 1934 the Birches organized three corporations—(1) the taxpayer-corporation, to which they transferred the Conaway Ranch and certain other property; (2) the Birch Securities Company, to which they transferred the 1,594 Reclamation District bonds (face value, $1,594,000) they held, as well as certain stocks and other assets; and (3) the Birch Holding Company, to which they transferred all of the stock of the other two corporations and which, in return, issued 49 per cent of its stock to Birch and 51 per cent to Birch's wife. The Securities Company and the Holding Company were formed for convenience and conducted no business. The taxpayer-corporation operated the Conaway Ranch. (R. 388.) As a result of the organization of these corporations, the taxpayer-corporation became liable for interest on the indebted-

[7] The Birches sold the bonds to Lulu Minter and the insurance company but, since the payment of the bonds was an obligation of the Birches as owners of the Conaway Ranch, the bonds represented the Birches' promise to repay the sale price of the bonds.

ness of the Birches to the Hopkins sisters, the insurance company and Lulu Minter, and, on the 1,594 bonds which the Birches had held and on which they were both payor and payee, the taxpayer-corporation became the payor and the Securities Company the payee. In the fiscal year 1944 the taxpayer-corporation, on "calls" by the county treasurer, paid $221,-610.87 for interest on Reclamation District bonds and this was for interest not only on the bonds outstanding in the hands of third parties but on bonds held by the Birches, the taxpayer-corporation itself, the Securities Company and the Holding Company.[8]

1. *Except as to the interest paid to the Hopkins sisters and Lulu Minter, deductibility is precluded by the fact that the payment of interest was not "on indebtedness" within the meaning of Section 23 (b)*

Section 23 (b) of the Code (Appendix, *infra*) authorizes a deduction of all interest paid or accrued within the taxable year "on indebtedness" with an exception which will be noted shortly. As to the bonds other than those held in the fiscal year 1944 by the Hopkins sisters and Lulu Minter, there was no real "indebtedness".

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[8] In making "calls" in the fiscal year 1944, the county treasurer computed an amount which, with any balance on hand, was sufficient to provide $60,000 for the semi-annual interest due on the bonds, and amounts paid as penalties were reflected in his computations. (R. 395.)

On September 30, 1943, the beginning of the 1944 fiscal year, the taxpayer-corporation held 86 bonds, those acquired from the insurance company; the Securities Company held the 1,594 bonds transferred to it at its organization; the Hopkins sisters held 310 bonds subject to the purchase contract with the Birches; and Lulu Minter held 10. On March 15, 1944, the Birches bought the 310 bonds from the Hopkins sisters and before the close of the fiscal year Securities was liquidated and dissolved. Thus at the close of the fiscal year 1944, the Birches held directly 310 of the 2,000 bonds; the Holding Company held 1,594 from the liquidation of Securities Company; the taxpayer-corporation held 86, and Lulu Minter 10. (R. 394.)

An indebtedness requires a creditor and debtor and those existed here only as a matter of form. The interest on bonds other than those held by the Hopkins sisters and Lulu Minter was interest payable *by* one of the Birches' wholly-owned corporations, the taxpayer-corporation, and payable *to* the Birches and their wholly-owned corporations. From a substantive standpoint, the interest paid by the taxpayer-corporation for interest on bonds other than those held by the Hopkins sisters and Lulu Minter was a payment of interest by the Birches to themselves. The payor and payees were economically identical.

In *Prudence Securities Corp.* v. *Commissioner,* 135 F. 2d 340 (C.A. 2d), it was held that no deduction is allowable for interest paid when payor and payee are, as here, economically ~~identical~~ identical. See also *Elbert v. Commissioner,* 45 B.T.A. 685. That holding is manifestly correct, for there have been many situations in which the separate identity of a corporation has been ignored for tax purposes. Taxation is an intensely practical matter concerned with economic realities and substance controls over form.[9] For example, in *Higgins* v. *Smith,* 308 U. S. 473, it was held that the separate identity of the taxpayer's controlled corporation should be ignored in considering the tax effect of transactions between the taxpayer and the corporation. In that case the Supreme Court stated (pp. 477-478):

> A taxpayer is free to adopt such organization for his affairs as he may choose and having elected to

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[9] *Commissioner* v. *Sunnen,* 333 U.S. 591; *Helvering* v. *Clifford,* 309 U.S. 331; *Helvering* v. *Stuart,* 317 U.S. 154; *Harrison* v. *Schaffner,* 312 U.S. 579; *Douglas* v. *Willcuts,* 296 U.S. 1; *Corliss* v. *Bowers,* 281 U.S. 376; *Burnet* v. *Wells,* 289 U.S. 670; *Commissioner* v. *Court Holding Co.,* 324 U.S. 331; *Griffiths* v. *Commissioner,* 308 U.S. 355; *Gregory* v. *Helvering,* 293 U.S. 465; *Weiss* v. *Stearn,* 265 U.S. 242; *United States* v. *Phellis,* 257 U.S. 156; *Gulf Oil Corp.* v. *Lewellyn,* 248 U.S. 71; *Southern Pacific Co.* v. *Lowe,* 247 U.S. 330.

do some business as a corporation, he must accept the tax disadvantages.

On the other hand, the Government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him. The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute. To hold otherwise would permit the schemes of taxpayers to supersede legislation in the determination of the time and manner of taxation. It is command of income and its benefits which marks the real owner of property.

When the corporate entities of the Birches' wholly-owned corporations are ignored, as they should be, only the interest paid by the taxpayer-corporation on the bonds held by the Hopkins sisters and Lulu Minter was paid "on indebtedness" and is deductible.

2. *Except as to the interest paid to the Hopkins sisters and Lulu Minter, deductibility is precluded by the fact that section 122 (d)(2) was intended by Congress to prevent the deduction of interest paid to carry tax-exempt bonds to the extent that no economic loss was sustained by the payment of such interest*

There is still another reason why the taxpayer-corporation's payments of interest in the fiscal year 1944 are not deductible (except in part) and it is a reason which makes it clear beyond any doubt that the instant situation is of a type requiring that the separate entity of the Birches' wholly-owned corporations should be ignored.

Although Section 23 (b) of the Code authorizes a deduction for interest paid on indebtedness, an exception is made in the case of interest paid—

> on indebtedness incurred or continued to purchase or carry obligations * * * the interest upon which is wholly exempt from the taxes imposed by this chapter.

This provision is also treated specially for carry-back deduction purposes. As already stated, the "net operating loss" of any particular year is defined in Section 122 (a) as meaning the excess of deductions over the gross income for that year "with the exceptions, additions, and limitations provided in subsection (d)". Those exceptions, additions, and limitations include the following:

> (2) There shall be included in computing gross income the amount of interest received which is wholly exempt from the taxes imposed by this chapter, decreased by the amount of interest paid or accrued which is not allowed as a deduction by section 23 (b), relating to interest on indebtedness incurred or continued to purchase or carry certain tax-exempt obligations; * * *

When Congress enacted the net operating loss deduction provisions in 1939, it stated its intent with respect to these exceptions, additions and limitations to be as follows (H. Rep. No. 855, 76th Cong., 1st Sess, p. 17 (1939-2 Cum. Bull. 504, 517)):

> The net operating loss deduction is the net operating loss carry-over reduced by certain adjustments intended to prevent net losses from being used as a deduction by the taxpayer where he is not suffering any *economic* loss by reason of the fact that his income contains nontaxable items (as in the case of percentage depletion, *exempt interest on State and local bonds,* and, with respect to corporations, intercorporate dividends, and interest on partially exempt Federal obligations).
>
> * * * * *

> *The exceptions and limitations provided in section 122 (d) are for the purpose of insuring that only an* ECONOMIC loss will be *taken into account.* It is provided that in computing gross income, wholly tax-exempt interest, diminished by the amount of interest paid or accrued not allowed as a deduction by section 23 (b), relating to interest on indebtedness incurred or continued to purchase or carry certain tax-exempt obligations, shall be included, * * * [Italics supplied.]

The interest received by holders of the Reclamation District bonds was tax-exempt interest, as Mr. Birch himself testified. (R. 286; see also, R. 58, 86, 166, 183, 186, 187, 188.) The interest paid by the taxpayer-corporation was of course paid to carry the bonds, and thus paid to carry "obligations * * * the interest upon which is wholly exempt from the taxes imposed by this chapter" within the meaning of Section 23 (b) of the Code. Cf. *First Nat. Bank* v. *United States,* 283 U. S. 142.

The Birches sustained no *economic* loss by payment of interest on the bonds, through the taxpayer-corporation, on "calls" of the county treasurer, to the extent that the interest was repaid to the Birches either individually or through their wholly-owned corporations, the Birch Securities Company and the Birch Holding Company. And, since it was the Congressional purpose to allow a deduction of interest paid to carry tax-exempt bonds only to the extent that an *economic* loss was sustained, it necessarily follows that the separate entity of the taxpayer-corporation, the Birch Securities Company and the Birch Holding Company should be ignored in computing net operating loss of the taxpayer-corporation for the fiscal year 1944. By Section 122 (d)(2) Congress intended that the interest paid to carry tax-exempt bonds should be deductible only against the interest received from such bonds. The tax-

payer-corporation did not report the tax-exempt interest received by the Birches, the Birch Securities Company, the Birch Holding Company, nor apparently even by itself, and accordingly is not entitled to deduct interest paid to carry the bonds on which the tax-exempt interest was received.

It is not entirely clear that the interest paid by the taxpayer-corporation on the bonds held by the Hopkins sisters and Lulu Minter is deductible. That interest was also in a sense paid to carry tax-exempt bonds. On the other hand, the bonds held by Hopkins sisters and Lulu Minter really represented personal obligations of the Birches and the Birches received no tax-exempt benefit from interest paid on those bonds. From the standpoint of substance, the situation with respect to those bonds was the same as if the Birches were paying interest on indebtedness consisting of the purchase price of the Hopkins sisters' interest in the Conaway ranch and on a loan from Lulu Minter. We therefore do not contend that the interest paid to the Hopkins sisters and Lulu Minter during the fiscal year 1944 was not deductible.[10]

C. *The Tax Court's holding that taxpayer's total $221,610.87 payment is deductible as taxes paid is in conflict with the purpose of Section 122 (d)(2)*

As has been seen, Congress intended by Section 122 (d)(2) to insure that only *economic* losses would be taken into account in computing net operating loss for the purpose of a carry-back deduction to a prior year. Even if the aggregate $221,610.87 payment made by

[10] In the previous case relating to the deductibility of interest paid by the taxpayer-corporation, the Tax Court held that the interest paid to the Hopkins sisters during the years 1937 and 1939 was deductible. The Commissioner did not contend that such interest was not deductible because paid to carry tax-exempt bonds.

taxpayer in the fiscal year 1944 may be regarded as a payment of "taxes", it must be recognized that the arrangement resulting in the payment was unusual and not of the type commonly deemed to require the payment of "taxes". For present purposes, there is no reason to extend the deduction for taxes paid to such an arrangement; on the contrary, to do so is to thwart the Congressional purpose of Section 122 (d)(2). The Birches made the total $221,610.87 payment, through the taxpayer-corporation, and also received most of it back, either individually or through the Securities Company and Holding Company. Since the part they received back was tax-exempt interest, to hold that the taxpayer-corporation is entitled to deduct the total payment as a payment of "taxes" is to allow a deduction for that which was *not* an economic loss, contrary to the purpose of Section 122 (d)(2). The Congressional intent should always be effectuated if possible. It can be in the present case by a holding, amply justified, that the total $221,610.87 payment made by the taxpayer-corporation was not of, or should not be treated as of, taxes—that it was, or at least should be treated as, interest and as interest is not deductible in computing net operating loss.

CONCLUSION

The decision of the Tax Court is incorrect and should be reversed.

Respectfully submitted,

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NOVEMBER, 1950.

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

(c) [as amended by Sec. 202 (a) of the Revenue Act of 1941, c. 412, 55 Stat. 687, and Sec. 111 of the Revenue Act of 1943, c. 63, 58 Stat. 21] *Taxes Generally.*—

(1) *Allowance in general.*—Taxes paid or accrued within the taxable year, except—

* * * * *

(E) taxes assessed against local benefits of a kind tending to increase the value of the property assessed; but this paragraph shall not exclude the allowance as a deduction of so much of such taxes as is properly allocable to maintenance or interest charges; and

* * * * *

(s) [as added by Sec. 211(a) of the Revenue Act of 1939, c. 247, 53 Stat. 862] *Net Operating Loss Deduction.*—For any taxable year beginning after December 31, 1939, the net operating loss deduction computed under section 122.

(26 U. S. C. 1946 ed., Sec. 23.)

SEC. 122 [as added by Sec. 211 (b) of the Revenue Act of 1939, *supra*] NET OPERATING LOSS DEDUCTION.

(a) [as amended by Sec. 105 (e)(3)(A) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Definition of Net Operating Loss.*—As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

(b) [as amended by Sec. 153 (a) of the Revenue Act of 1942, *supra*] *Amount of Carry-Back and Carry-Over.*—

(1) *Net operating loss carry-back.*—If for any taxable year beginning after December 31, 1941, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-back for each of the two preceding taxable years, except that the carry-back in the case of the first preceding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the second preceding taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d)(1), (2), (4), and (6), and (B) by determining the net operating loss deduction for such second preceding taxable year without regard to such net operating loss.

* * * * *

(d) [as amended by Sec. 105 (e)(3)(C) of the Revenue Act of 1942, *supra*] *Exceptions, Additions, and Limitations.*—The exceptions, additions, and limitations referred to in subsections (a), (b), and (c) shall be as follows:

* * * * *

(2) There shall be included in computing gross income the amount of interest received which is

wholly exempt from the taxes imposed by this chapter, decreased by the amount of interest paid or accrued which is not allowed as a deduction by section 23 (b), relating to interest on indebtedness incurred or continued to purchase or carry certain tax-exempt obligations;

* * * * *

(26 U. S. C. 1946 ed., Sec. 122).

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.23(c)-3. *Taxes for Local Benefits.*—So-called taxes, more properly assessments, paid for local benefits, such as street, sidewalk, and other like improvements, imposed because of and measured by some benefit inuring directly to the property against which the assessment is levied, do not constitute an allowable deduction from gross income. A tax is considered assessed against local benefits when the property subject to the tax is limited to property benefited. Special assessments are not deductible, even though an incidental benefit may inure to the public welfare. The real property taxes deductible are those levied for the general public welfare by the proper taxing authorities at a like rate against all property in the territory over which such authorities have jurisdiction. Assessments under the statutes of California relating to irrigation and of Iowa relating to drainage, and under certain statutes of Tennessee relating to levees, are limited to property benefited, and if the assessments are so limited, the amounts paid thereunder are not deductible as taxes. The above statements are subject to the exception that in so far as assessments against local benefits are made for the purpose of maintenance or repair or for the purpose of meeting interest charges with respect to such benefits, they are deductible. In such cases the burden is on the taxpayer to show the allocation of the amounts as-

sessed to the different purposes. If the allocation cannot be made, none of the amounts so paid is deductible.

SEC. 29.122-1. *Net Operating Loss Deduction.*—(a) *General.*—Section 122 provides the rules for the computation of the net operating loss deduction allowed by section 23 (s). The net operating loss deduction is the aggregate of the net operating loss carry-overs and carry-backs to the taxable year, reduced by certain adjustments to prevent the deduction of losses absorbed by income not taxed.

* * * * *

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